SEMLER BROSSY

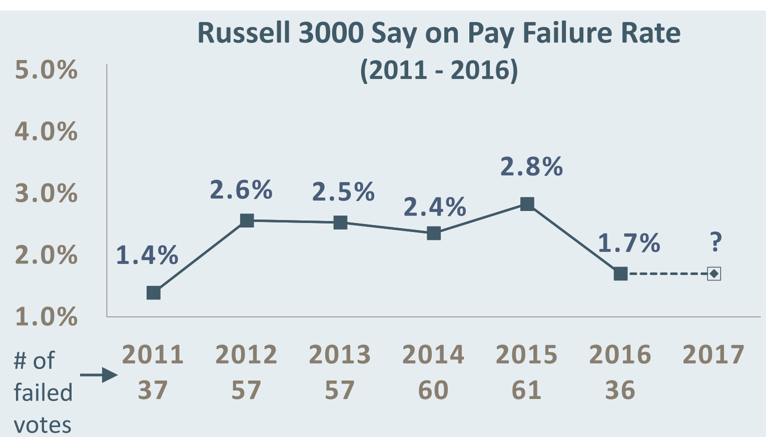
Predictions for the 2017 Proxy Season

Throughout the year, we will release periodic articles exploring vote results, trends, and other intriguing proxy-related considerations. Some issues will build upon topics explored in our standard bi-weekly report, while others will tackle new topics. For this issue, we give four predictions for 2017:

Prediction 1: The 2017 Say on Pay failure rate will fall to its lowest level since voting began in 2011.

The Say on Pay failure rate for Russell 3000 companies was within a narrow range of 2.4% and 2.8% between 2012 and 2015. Similarly, the average vote result in the same period ranged from 89.9% and 90.9%. These previous results suggested a predictable range of results for 2016; however, the percentage of failed companies in 2016 noticeably dropped year-over-year from 2.8% to 1.7%.

The sharp decline is likely attributable to a number of factors, including the normalization of Say on Pay practices, increased communication between companies and major shareholders, more robust and reader-friendly proxies, and better alignment of programs with institutional investor policies.



As we enter 2017, we predict the same underlying drivers that led to the decrease in the failure rate in 2016 will continue to push the failure rate to the lowest level we have observed since the introduction of Say on Pay in 2011. While there are some questions surrounding the future of Say on Pay (and other Dodd-Frank regulations) under the current presidential administration, we expect pay programs and pay levels will continue to be designed with shareholder and proxy advisor opinions in mind. If this is indeed the case, we can expect to see even fewer companies fail Say on Pay.

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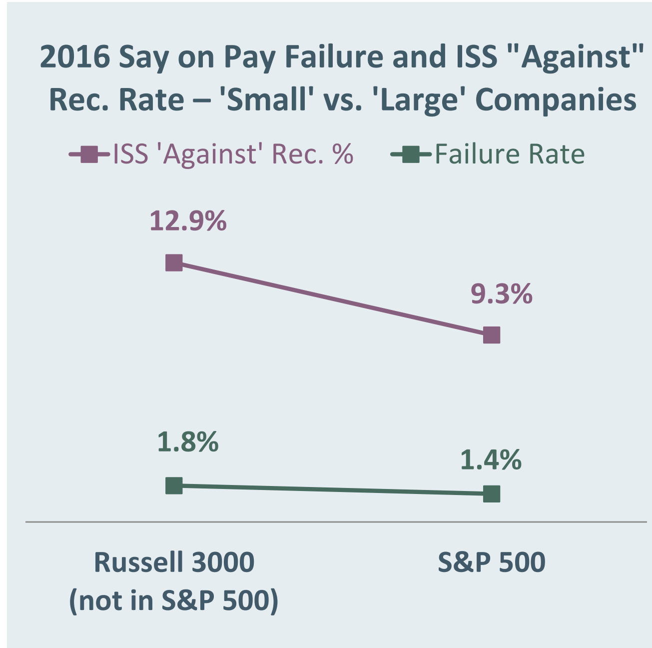
This year's Say on Pay results will include significantly more votes than prior years, as this is the first occasion since 2011 that companies on an annual, biennial, and triennial vote frequency have had Say on Pay votes in the same year. An initial review of the data does not suggest that the inclusion of these companies will contribute to a higher failure rate in 2017.

Prediction 2: Smaller companies will continue to fail Say on Pay more frequently than larger companies.

We have shown in prior reports that a meaningful difference exists between the Say on Pay failure rate at smaller companies (Russell 3000 constituents not in the S&P 500) and larger companies (companies in the S&P 500). During the 2016 voting season, the failure rate among smaller companies was 1.8%, or 0.4% higher than that among larger companies. ISS vote recommendations further suggest a disconnect between the two groups, as smaller companies received an "Against" recommendation 12.9% of the time versus 9.3% at larger companies.



The reasons behind the difference in failure rates between large and small companies are likely attributable to (i) the level of resources dedicated to ensure a passing vote, and (ii) the impact a negative vote will have on the public's perception of a company.

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Engaging with shareholders and proxy advisors—all while drafting a proxy filing and finalizing pay decisions at the beginning of the fiscal year—is time consuming and can require significantly more resources than many small companies have at their disposal. Many large companies, on the other hand, have staff devoted to governance matters that can focus on shareholder outreach.

This extra attention likely increases the ability of larger companies to address shareholder concerns, whereas smaller companies may not have the necessary resources to conduct such meaningful outreach.

Prediction 3: Shareholders will support an annual Say on Pay vote at over 90% of companies holding frequency votes in 2017.

The SEC requires companies to hold a vote determining how frequently shareholders have the opportunity to cast a non-binding ballot in favor of (or against) a company's pay programs for top executives—otherwise known as a Say on Pay frequency vote. Under the legislation, shareholders may elect to have a Say on Pay vote every year, every other year, or every third year.

Additionally, the SEC requires that companies hold frequency votes no later than the sixth anniversary of their most recent frequency vote, meaning 2017 will be the second round of frequency votes for companies that held their first frequency vote in 2011. We expect the issue will be more prominent throughout the upcoming proxy season compared to years prior given the large increase in companies holding a Say on Pay frequency vote in 2017.

We believe three drivers will lead voters to favor an annual vote at over 90% of companies: (i) annual Say on Pay votes are a relatively easy "good governance" practice for companies to implement, (ii) management at Russell 3000 companies have recommended "For" annual votes at an increasing rate over the last few years, and (iii) proxy advisors have a stated policy of recommending "For" annual votes.

Unlike making material changes to compensation programs, adopting an annual Say on Pay vote is relatively easy to implement into the existing annual proxy cycle and gives shareholders a platform on which they can express their concerns (or lack thereof) with a pay program. In recent years we have seen management buy into this notion–management recommendation rates for annual votes rose from 54% in 2013 to 80% in 2016.

In exchange for a relatively simple adoption, boards and management teams can increase the robustness of governance practices and responsiveness to shareholder concerns.

Regardless of the motivation, the increase in management recommendations for an annual Say on Pay vote has had a direct impact on actual vote outcomes, as the percentage of companies adopting an annual vote rose from 63% to 86% over the period between 2013 and 2016.

We feel confident shareholders will continue to disproportionately support an annual voting cadence, especially when taking into account the large proxy advisors have a stated policy of recommending “For” annual votes.

Prediction 4: Median support for environmental-related proposals will be above 30% in 2017

Climate change has been a focus of U.S. policy over the last six years, evidenced by a tightening of EPA regulations, local and national debates about hydraulic fracturing, and the signing of the Paris Climate Agreement; however, the current administration has committed to rolling back many of the regulations enacted by the Obama administration

Since 2011, shareholders have shown an increased interest in climate change, sustainability, and environmental issues. 78 environmental proposals were submitted for approval by shareholders at Russell 3000 companies in 2016, more than double the 38 proposals submitted in 2011. The median vote result of an environmental proposal in 2016 was 25.7%, 5.6% higher than in 2011.

We believe that median vote support for environmental proposals will climb above 30% in 2017, and many will have the potential to garner 50%+ support, particularly at oil and gas manufacturing companies that are most sensitive to climate change regulation and initiatives.

Weakened federal environmental regulations may also prompt shareholders to push their own environmental agenda more strongly. Evidence includes BlackRock (March 2017) and State Street (January 2017) statements that shareholders should address climate change as a global risk, and that companies should “have demonstrable fluency in how climate risk affects [their] business.”

SAY ON PAY TEAM:

TODD SIRRAS
MANAGING DIRECTOR

AUSTIN VANBASTELAER
SENIOR ASSOCIATE

ROB STORRICK
SENIOR ASSOCIATE

KAYLA DAHLERBRUCH
ASSOCIATE

SPECIAL THANKS TO **CHARLES GRAY**, CONSULTANT

FOR MORE INFORMATION, VISIT US AT
SEMLERBROSSY.COM OR PLEASE CONTACT:

SEMLER BROSSY CONSULTING GROUP, LLC
11755 WILSHIRE BLVD. 10TH FLOOR
LOS ANGELES CA 90025
(310) 481-0180
INFO@SEMLERBROSSY.COM

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